SFAS 87

What Effect So Far?

By Mary Ann Merryman

SFAS 87 has made significant changes in employer's accounting for pension plans. Most of the changes are now required disclosure, however the requirement to record an additional minimum pension liability was delayed to 1988. This paper summarizes the changes imposed by SFAS 87 and discusses the effect of these changes on companies' financial statements in the year of adoption, as well as the future effect when the remainder of the statement becomes effective.

In December 1985, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 87 "Employers' Accounting for Pensions". It superseded Accounting Principles Board (APB) Opinion No. 8 "Accounting for the Cost of Pension Plans" and SFAS No. 36 "Disclosure of Pension Information". This statement was the result of a ten year study of pension accounting by the FASB. From 1980 to the end of 1985, the FASB issued two discussion memorandums, a preliminary views document, two exposure drafts and witnessed 151 presentations over thirteen days of public hearings prior to issuing the final statement. The length of time the project required indicates the importance of and the controversy surrounding the topic. There was controversy even within the Board itself, as indicated by the four to three vote on the final statement. With the exception of the minimum liability disclosure, SFAS 87 was effective for fiscal years beginning after December 15, 1986. The FASB encouraged early adoption and numerous companies elected to do so.

What Were the Changes?

The FASB's goal in developing SFAS 87 was greater consistency in pension accounting. The objectives of the statement, as described in paragraph 6 are:

a. to provide a measure of net periodic pension cost that is more representationally faithful than those used in past practice because it reflects the terms of the underlying plan and because it better approximates the recognition of the cost of an employee's pension over that employee's service period;

b. to provide a measure of net periodic pension cost that is more understandable and comparable and is, therefore, more useful than those in past practice;

c. to provide disclosures that will allow users to understand better the extent and effect of an employer's undertaking to provide employee pensions and related financial arrangements; and

d. to improve reporting of financial position.

With these objectives, the FASB made changes in four areas:

#1) SFAS 87 requires a standardized method of measuring annual pension expense. As prescribed in paragraphs 20 through 34 and in paragraph 77, net pension expense will now be derived from six components:

1. Service cost (increases pension expense) - This component is the actuarial present value of benefits attributed by the pension benefit formula to employee service for the current year, measured by using the projected unit credit method with salary progression, if applicable, and discounted to present value using a current discount rate. APB 8 permitted a choice among several actuarial methods and allowed the use of very conservative discount rates.

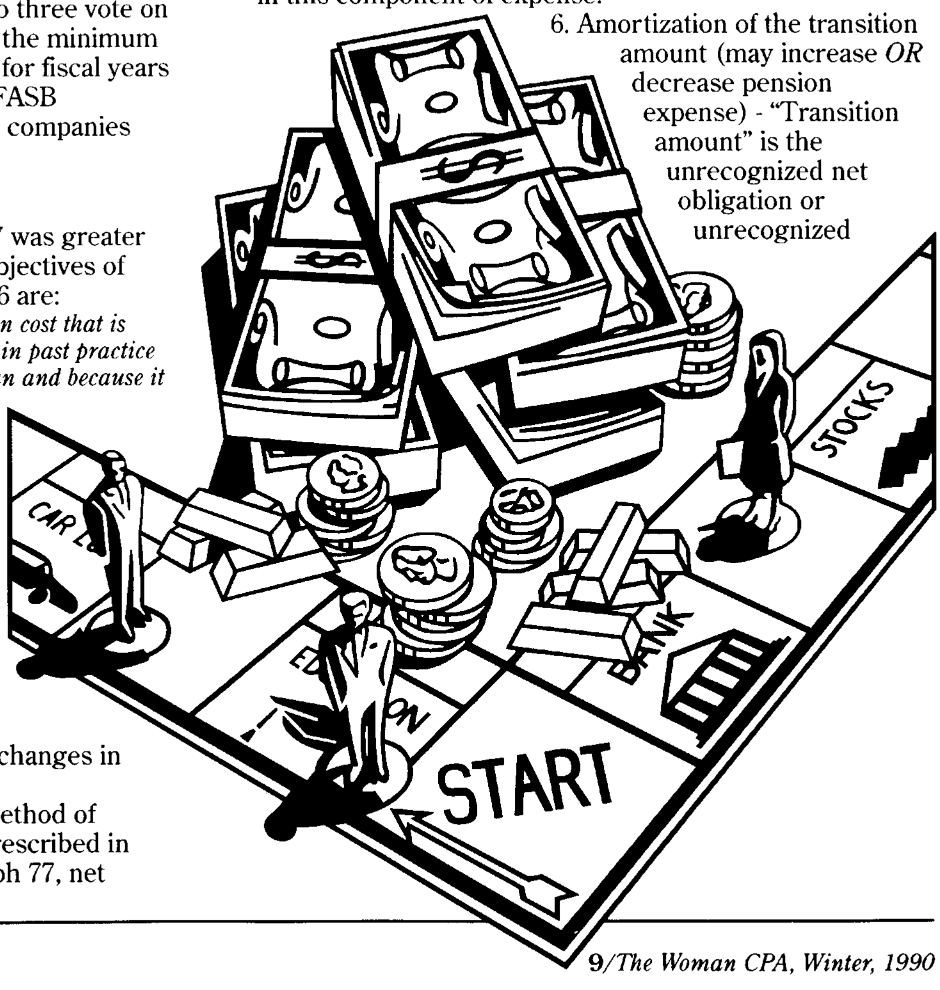
2. Interest cost (increases pension expense) - This component is the increase in the projected benefit obligation due to the passage of time, using a settlement-basis discount rate.

3. Actual return on plan assets (decreases pension expense) - This component is the difference between the fair value of plan assets at the beginning of the period and the fair value at the end of the period, adjusted for contributions and payments of benefits during the period. (Adjustment to expected return is included in the gains or losses component).

4. Amortization of unrecognized prior service cost (generally increases pension expense) - This is a new method of amortization required by the FASB.

5. Amortization of gains and losses (may increase OR decrease pension expense) - This component represents the changes in the amount of either the projected benefit obligation or the plan assets resulting from experience different than assumed and from changes in assumptions. Amortization is now calculated using the "corridor approach" which helps to eliminate some of the volatility in this component of expense.

6. Amortization of the transition amount (may increase *OR* decrease pension expense) - "Transition amount" is the unrecognized net obligation or unrecognized



net asset existing at the date of initial application of SFAS 87. This amount represents a "fresh start" in that it includes the unamortized amounts for any plan amendments or actuarial gains and losses that arose before initial application of SFAS 87. This amortization provides some relief in pension cost.

Change #2) Under SFAS 87, the cost of retroactive benefits are required to be recognized over the remaining service period of active employees. Recognition was previously allowed over a period of up to forty years.

Change #3) A new "minimum liability" is required to be recorded when the accumulated benefit obligation under the pension plan exceeds the fair value of plan assets. No such disclosure has been required previously. This new liability need not be reflected on the balance sheet until fiscal years beginning after December 15, 1988.

Change #4) Significant additional disclosures are required. SFAS No. 88 "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pensions Plans and for Termination Benefits" was also issued at the same time as SFAS 87, changing significantly the accounting for pension plan terminations, settlements and curtailments.

What has Been the Effect of These Changes?

The Wall Street Journal [Crossen, 1988] has stated, "It (SFAS 87) has to be one of the most feared and misunderstood accounting rules of all time ... It may affect the way more than a trillion dollars is invested - and the lives of millions of people." Given the controversy mentioned above and the fact that many companies opposed the issuance of the statement, what has been the effect of the changes in calculating pension expense?

In order to evaluate the effect of the changes required by SFAS 87 on companies' financial statements, the annual reports of 100 publicly traded companies with defined benefit plans were examined for the year in which they made the transition from APB 8 to SFAS 87. Sixty-nine of the companies were included in Forbes 500 largest companies in the United States. The other 31 were smaller and not as well known. The objective was to determine the impact of the change on pension expense and/or net income (loss). Of the 100 companies examined, 72 elected early adoption of SFAS 87. Twenty-eight companies chose to implement the statement when required. Seventy-one of the 72 early adoptees were able to reduce pension expense under the new rules, or the change was not material.

Of the 100 companies, 28 were able to report pension income under the new statement. (See Exhibit A) This was possible primarily due to the offset of the return on pension plan assets when calculating net pension expense.

Sixty-five of the companies reported a decrease in pension expense in comparison to what expense would have been under APB 8. (See Exhibit B) Only three companies stated that pension expense had increased. (However, one of the companies with increased expense reported an increase of 50.4%)

What was the magnitude of the decrease in pension expense for the 65 companies? Some companies chose to disclose the impact as a decrease in pension expense. Others chose to show the increase in net income (decrease in net loss) as a result of decreased pension expense. Exhibit C shows the breakdown of those annual reports which disclosed the change in pension expense and those which disclosed the change in net income (loss). Thirteen companies reported a decrease in pension expense of over 100%. One company had an increase in net income of 121% due to implementing SFAS 87.

What About the New Minimum Liability?

Probably the most controversy surrounding SFAS 87 concerned the recording of an additional pension liability for underfunded plans. Previously, the only pension asset or liability on the balance sheet was prepaid or accrued pension cost originating if the company chose to fund, or pay into the plan, an amount greater than or less than pension expense recognized on the income statement. SFAS 87 will require some companies to record an additional liability on their balance sheets in

Exhibit A
Pension Expense vs. Pension Income

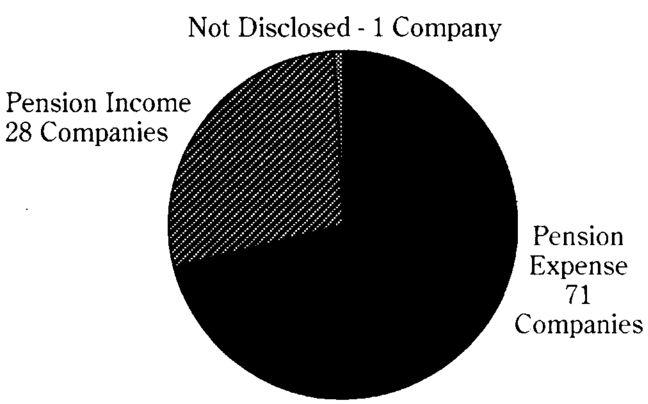
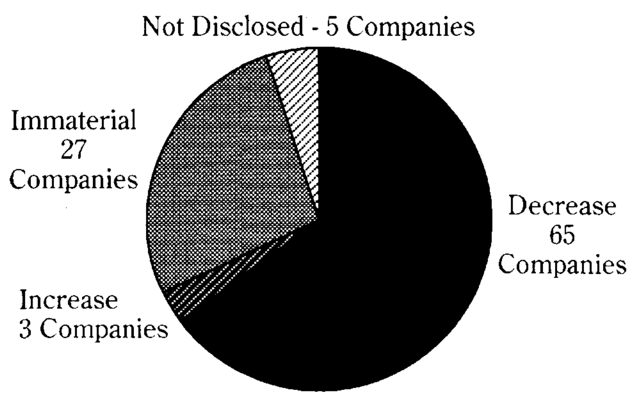


Exhibit B
SFAS 87 Effect on Pension Expense



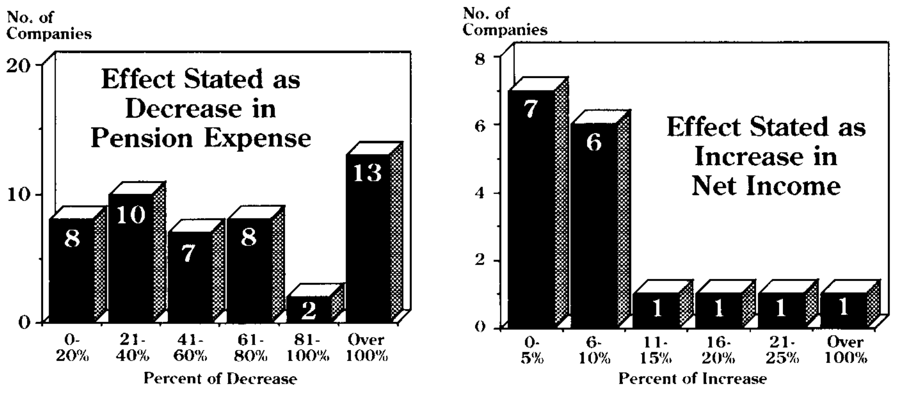
fiscal years beginning after December 15, 1988. Following the principle of conservatism, the FASB will not permit a company with plan assets in excess of obligations to record a pension asset.

Opponents of this liability argue that the assets and obligations of the pension plan are not general assets and liabilities of the employer, but are assets and liabilities of the plan itself and should appear only on the financial statements of the pension plan. This ongoing controversy as to "Whose money is it, anyway?" still continues despite SFAS 87.

The new minimum liability is the amount of any unfunded accumulated benefits, which is the difference between the accumulated benefit obligation and the fair value of the plan assets. The accumulated benefit obligation differs from the projected benefit obligation in that it is the actuarial present value of benefits earned to date without regard to the effects of future pay increases. In other words, it is a more conservative representation of the pension plan's future obligation, but would be an indication of the liability if the plan were terminated. The minimum liability is compared to the previously recorded prepaid or accrued pension cost and an additional liability is recorded, if necessary, to show a total pension liability equal to the minimum liability. If an additional liability is to be credited in situations where there are unfunded obligations, what is the offsetting debit? The FASB has stipulated that the debit will be to one of two accounts. The most common will be to an intangible asset that will not be amortized, but the balance of which will be adjusted as the additional liability is adjusted to the funding status at each fiscal year end. The argument in favor of recording an asset is that the unfunded benefits usually arise from plan amendments that are expected to benefit future periods. In those situations where the new liability exceeds the existing unrecognized prior service cost (from plan amendments), the excess is considered to have no future economic benefit and would be debited to a contra stockholders' equity account rather than to an intangible asset. Of the 100 companies examined in this study, 32 had unfunded accumulated obligations on the date of adopting SFAS 87. (See Exhibit D) Of the 32, 19 would have been required to record an additional pension liability in the year of transition if the FASB had not delayed this requirement. The amount of the additional liability would have ranged from $1 million (an immaterial percentage of the company's total assets) to $3.3 billion (5% of the company's total assets). Although the majority of the companies chose early adoption of the other SFAS 87 changes, only one company chose to record their additional liability early, in the transition year.

SFAS 87 does not permit companies with more than one pension plan to combine plans in determining the unfunded accumulated obligation unless the assets of one plan can be used to settle obligations in another. If allowed to combine plans, sixteen of the above nineteen companies, with additional liabilities, would not have calculated such a liability.

Exhibit C
Impact of Decrease in Pension Expense



The FASB initially proposed recording the difference between the projected benefit obligation and the fair value of plan assets and disclosing the full unfunded liability under the plan. However, as a result of responses to Preliminary Views and the Exposure Draft, concessions were made. "The Board believes that it would be conceptually appropriate and preferable to recognize a net pension liability ... measured as the difference between the projected benefit obligation and plan assets .... However, it concluded that [that approach] would be too great a change from past practice to be adopted at the present time." [SFAS 87, paragraph 107].

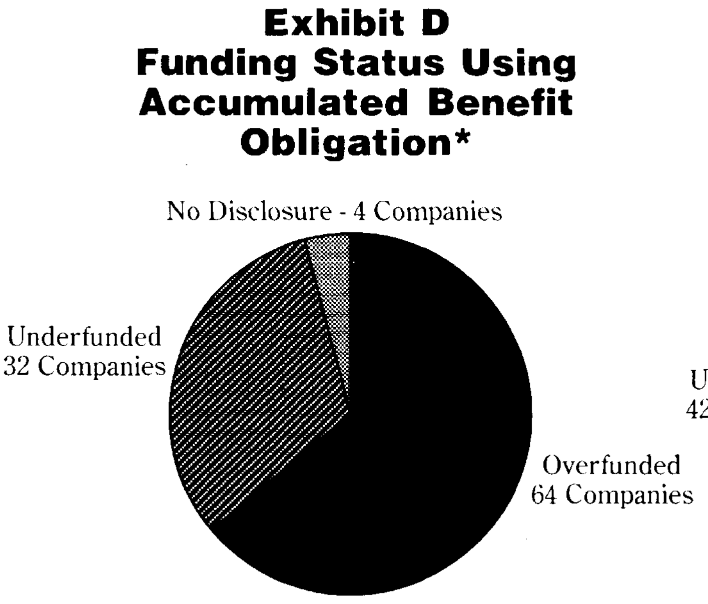
If the FASB, for purposes of the additional liability, and followed through with its proposal and required an additional liability based on the unfunded projected obligation, 42 of the 100 companies selected, rather than 32, would have been underfunded, and of the 42, 37 (versus 19 using the accumulated benefit obligation) would have calculated an additional pension liability (See Exhibit E).

Has Disclosure Been Improved?

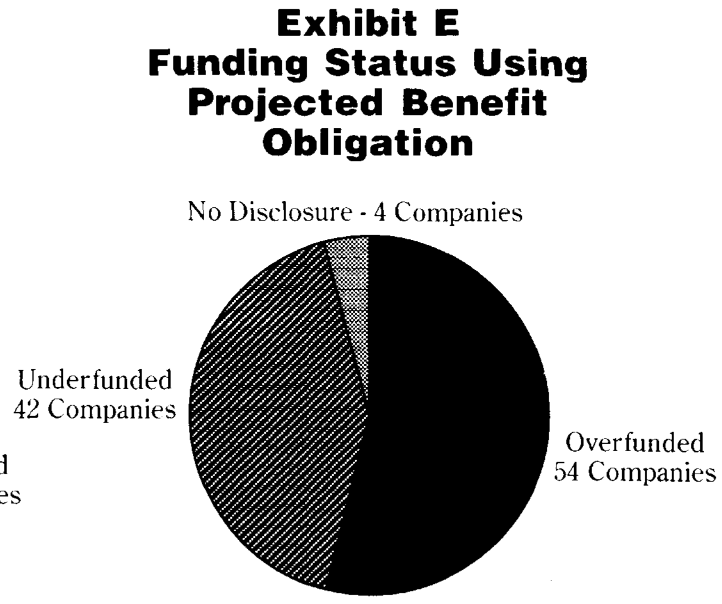
One objective of the FASB was to provide more meaningful and understandable footnote disclosure. The statement lists, in paragraph 54, the specific items to be included. Of the 100 companies examined, all but three appeared to have adequate disclosure. There were differences in how the information was presented but there was some degree of uniformity among the 97 detailed footnotes. The footnotes were still quite complex, however, and only a user with a reasonable degree of pension knowledge would actually understand what was presented. Given the complexities of pension plans, most likely this will always be true.

Conclusion

The Financial Accounting Standards Board set out, in SFAS 87, to (1) improve the measurement of annual pension cost on the income statement by making it more representationally faithful, more understandable and more comparable; (2) provide better pension disclosure; and (3) improve the reporting of



* Two companies disclosed only the projected benefit obligation and not the accumulated benefit obligation. Funding status for these companies is thus based on the projected benefit obligation



financial position. Based on the research conducted, it appears that goals 1 and 2 have been achieved. The standardization of determining pension expense (income) and of footnote disclosure will improve financial reporting but not without a significant impact. Financial statement users should be aware of this impact and of the effect SFAS 87 will have on net income during the period of transition, especially in comparison to fiscal years prior to adoption. Whether or not an improvement in the reporting of financial position will result from SFAS 87 has yet to be seen. If the additional liability were required at the same time as the remainder of the statement, some companies would have recorded significant new liabilities and assets/contra stockholders' equity accounts on their books. Whether or not this would have improved the balance sheet depends on how one views pension assets and obligations.

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